



NCUA
National Credit Union Administration

**OFFICE OF INSPECTOR
GENERAL**

**MATERIAL LOSS REVIEW OF
INDIANAPOLIS' NEWSPAPER FEDERAL CREDIT UNION**

**Report #OIG-21-11
12/15/2021**





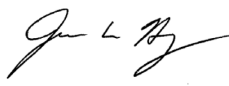
National Credit Union Administration

Office of Inspector General

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MEMORANDUM

TO: Distribution List

FROM: Inspector General James W. Hagen 

SUBJ: Material Loss Review of Indianapolis' Newspaper Federal Credit Union

DATE: December 15, 2021

The NCUA Office of Inspector General contracted with Moss Adams LLP to conduct a Material Loss Review of Indianapolis' Newspaper Federal Credit Union, a federally insured credit union. We reviewed the Credit Union to: (1) determine the cause(s) of the Credit Union's failure and the resulting estimated \$2.29 million loss to the Share Insurance Fund, (2) assess the NCUA's supervision of the Credit Union, including implementation of the prompt corrective action requirements of Section 216 of the Federal Credit Union Act, and (3) provide appropriate observations and/or recommendations to prevent future losses.

We determined the Credit Union failed due to alleged fraudulent activities perpetrated by the credit union's Chief Executive Officer, Credit Union employees, and the Chairman of the Credit Union's Board of Directors. As a result of our review, we made two observations and one recommendation to NCUA management related to the agency's Small Credit Union Examination Program. Management agreed with our recommendation and plans to take corrective action.

We appreciate the effort, assistance, and cooperation NCUA management and staff provided to us and our contractor during this review.

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Attachment

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EXECUTIVE SUMMARY

The National Credit Union Administration (NCUA) Office of Inspector General (OIG) contracted with Moss Adams LLP (Moss Adams) to conduct a Material Loss Review (MLR) of Indianapolis' Newspaper Federal Credit Union ("INFCU" or "the Credit Union"), a federally insured credit union. We reviewed the Credit Union to: (1) determine the cause(s) of the Credit Union's failure and the resulting estimated \$2.29 million loss to the Share Insurance Fund (SIF), (2) assess the NCUA's supervision of the Credit Union, including implementation of the prompt corrective action requirements of Section 216 of the Federal Credit Union Act (FCU Act), and (3) provide appropriate observations and/or recommendations to prevent future losses.

To achieve these objectives, we analyzed NCUA examination and supervision reports and related correspondence for the period September 30, 2016, through June 30, 2020. We interviewed NCUA officials and regional staff and reviewed NCUA guidance, including regional policies and procedures and NCUA 5300 Call Reports (Call Reports).

We determined the Credit Union failed due to alleged fraudulent activities perpetrated by the Credit Union's Chief Executive Officer ("CEO" or "Manager"), Credit Union employees, and the Chairman of the Credit Union's Board of Directors ("Chairman" or "Board Chairman"). The alleged fraud was executed through a loan lapping scheme, a practice that involves falsifying internal loan records to hide misappropriated cash. Cash proceeds from the alleged fraudulent loans, or alleged fraudulent advances on loans, were used to make payments on existing loans, thus concealing levels of delinquencies at the Credit Union. Approximately \$1.3 million of alleged fraudulent loans were identified as part of the loan lapping scheme from July through September 2020. NCUA Southern Region Officials determined the Credit Union to be insolvent and executed liquidation orders for the Credit Union on March 31, 2021.

The following factors created an environment in which such misstatement could go undetected.

Lack of Management Integrity

Management displayed a lack of integrity and did not manage the Credit Union in the best interest of its members. Examiners discovered approximately \$1.3 million of alleged fraudulent loans, of which Credit Union staff had recorded loan payments primarily from alleged fraudulent loan advances rather than from the borrower. Additionally, the CEO allegedly falsified loan documentation to provide better rates and additional loan advances to herself and related parties. All three Credit Union staff, including the CEO, were allegedly involved in the loan lapping scheme, and were terminated by the Credit Union's Board of Directors shortly after the alleged fraud was identified by the NCUA.

Ineffective Board Oversight

We believe the Credit Union's Board of Directors failed in their responsibilities to oversee the activities of the Credit Union. Specifically, the Chairman of the Board was allegedly



involved in the loan lapping scheme. Examiners identified instances of alleged fraudulent loan advances being used to make payments on loans to the Chairman and his spouse. Based on our review, we believe loan documentation for several loans to the Board Chairman to be falsified.¹ Evidence also suggests the Board Chairman may have colluded with the Credit Union's CEO to falsify documentation requested by NCUA examiners. The Board Chairman resigned shortly after NCUA examiners identified evidence of the loan lapping scheme.

Unsafe and Unsound Lending Practices

The Credit Union failed to manage its loan portfolio in a safe and sound manner. Specific examples relate to loan concentrations to a single borrower (or "household") and inadequate credit risk management for unsecured loans. The Credit Union consistently granted loans to one member, or one household, of greater than 25 percent of the Credit Unions' net worth. Examiners noted levels of loan concentrations to one member of 47 percent of the Credit Unions' net worth during a particular exam. The individual had the potential to negatively impact the Credit Union's net worth to prompt corrective action level if they were to experience a significant loss. Additionally, the Credit Union did not evaluate unsecured debt in relation to income to manage credit risk. Although examiners communicated the issues as a concern, the Credit Union failed to execute and implement adequate credit risk management policies addressing elevated concentration risk, or risks related to unsecured lending.

We also determined the NCUA may have identified the alleged fraud sooner and mitigated the loss to the SIF had it more thoroughly addressed certain risks identified through completion of the Small Credit Union Examination Program (SCUEP) and performed suggested additional procedures as a response to the risks identified.

As a result of our review, we are making one recommendation to NCUA management related to loan concentrations to a single borrower or associated borrowers.

We appreciate the effort, assistance, and cooperation NCUA management and staff provided to us during this review.

¹ In late 2020, the INFCU Board of Directors engaged a third party to conduct a fraud investigation of certain activities and improper actions of the Credit Union's former CEO, staff, and Board Chairman. One of the conclusions of the investigation was that loan documents for several loans to the board chairman were falsified.



BACKGROUND

The OIG contracted with Moss Adams to conduct an MLR for the Credit Union as required by Section 216 of the Federal Credit Union Act, 12 U.S.C. 1790d(j). The Credit Union was federally chartered and located in Indianapolis, Indiana. The NCUA's Southern Region provided supervision over the Credit Union.

General History of the Credit Union

The NCUA chartered Indianapolis' Newspaper Federal Credit Union in 1961. The Credit Union primarily served current and past employees of the Indianapolis Star and their family members in the state of Indiana. The Credit Union had one branch location and three employees. According to the Credit Union's final Call Report, dated March 31, 2021, INFCU reported total assets of \$6.28 million and membership of 1,143.

Results of NCUA examinations performed during the review period of September 2016 to June 2020 indicate generally declining regulatory ratings. INFCU received a CAMEL² Composite rating of 2 as a result of the 2016 and 2017 examinations and a CAMEL Composite rating of 3 for the 2018 and 2019 examinations. No Documents of Resolution (DORs) were issued during the 2016 and 2017 examinations. However, several Examiner's Findings related to credit risk were documented within the 2016 and 2017 examination reports. Specific findings included in the reports related to Risk Based Lending Policy limits, loans paid ahead by several months, and loans for which accrued interest was greater than the loan balance, among others.

During the examination effective September 30, 2018, the examiner in-charge (EIC) issued four DORs related to the earnings of the Credit Union, implementation of an "Earnings Plan," maximum indebtedness limit for loans to one borrower or associated borrowers (or loans to one "household"), and unsecured lending limits. The Credit Union had not been profitable since the fiscal year ended December 31, 2015. A follow-up examination effective March 31, 2019, resulted in resolution of the unsecured lending limit DOR.

During the examination effective September 30, 2019, the EIC issued one DOR related to the earnings plan of the Credit Union. The DOR related to the maximum indebtedness limit was considered resolved as management implemented a \$150,000 maximum aggregate loan amount per household. Although the number of DORs improved during this examination, examiners did still document Examiner's Findings over loan concentrations to one household and the Allowance for Loan & Lease Losses (ALLL). The Credit Union continued to experience a net loss.

² The acronym CAMEL derives its name from the following components: [C]apital Adequacy, [A]sset Quality, [M]anagement, [E]arnings, and [L]iquidity/Asset-Liability Management.



The table below provides composite and specific CAMEL ratings for the applicable examinations during the period of our review:

NCUA Examination Results for INFCU**							
Examination Effective Date	Exam Type ³	CAMEL Composite	Capital / Net Worth	Asset Quality	Management	Earnings	Liquidity
September 2016	10	2	2	2	2	3	2
September 2017	10	2	2	2	3	3	2
September 2018	10	3	3	4	3	4	2
March 2019	22	3	3	4	3	4	2
September 2019	10	3	3	3	3	3	2
March 2020	90	NA	NA	NA	NA	NA	NA
June 2020	90	4	4	4	5	4	3

**Source: NCUA Examination Files

Identification of Alleged Fraud

On July 13, 2020, NCUA Southern Region Examiners identified certain anomalies while completing a delinquency calculator on a random sample of loans during a routine supervision contact. The delinquency calculator, while not a required examination procedure, is designed as a reasonableness test over the accuracy of the Credit Union's delinquent loan schedule. After identifying certain anomalies within the initial random sample of delinquent loans, examiners expanded testing to the entire loan portfolio and identified potentially fraudulent transactions. After identifying the alleged fraud, the examiners worked with the Division of Special Actions (DSA) to review the loans in question, as well as their payment histories and sources of repayment.

NCUA examiners and the DSA ultimately identified evidence of a loan lapping scheme, which was communicated to the INFCU Board of Directors on July 17, 2020. Approximately \$1.3 million of fraudulent loans were included in the scheme, of which Credit Union staff had recorded loan payments primarily from fraudulent loan advances rather than from the borrower. The INFCU Board terminated all three Credit Union staff involved in the alleged scheme, and the Board Chairman (who was suspected to be involved) resigned.

Prior to identification of the alleged fraud, the Credit Union had been unprofitable for four calendar years, experiencing a cumulative net loss of \$394,000 from January 1, 2016, to December 31, 2019. The loan lapping activity had concealed loan delinquencies and losses at the Credit Union. After the loan lapping scheme was identified in July 2020, the Credit Union increased funding to the ALLL in September 2020 and recorded a provision for loan loss

³ NCUA Work Classification Code (WCC) Examination Type 10 is a regular examination of a federally chartered credit union. WCC Examination Type 22 is an on-site supervision contact of a federally chartered credit union. WCC Examination Type 90 is on-site time spent at a federally chartered credit union specifically related to investigating and/or documenting a probable or known fraud.



expense of approximately \$700,000. Due primarily to this expense, the Credit Unions' net worth ratio declined from 9.20 percent as of June 30, 2020, to (1.88 percent) as of September 30, 2020.

On January 14, 2021, NCUA conserved INFCU due to a continued deterioration in the Credit Union's financial condition, as well as the NCUA's inability to find a credit union interested in an assisted merger with the Credit Union. The Regional Director (RD) of the Southern Region requested NCUA Board approval to place INFCU into involuntary liquidation in March 2021, with a projected loss of \$2.29 million to the SIF. The RD signed the Order of Liquidation on March 31, 2021. Problem areas identified by the NCUA included high-risk loan portfolio, alleged fraudulent activity, staffing for operations, and financial insolvency.

Mechanism of Alleged Fraud

The alleged fraud revolved primarily around a loan lapping scheme, a practice that involves falsifying internal loan records to hide misappropriated cash. INFCU's alleged fraud primarily utilized cash obtained from alleged fraudulent loans, or alleged fraudulent advances on loans, to make payments on existing loans, thus concealing levels of delinquencies and uncollectible loans reported at the Credit Union. In addition to misappropriating funds through the alleged loan lapping scheme, the CEO and Credit Union staff allegedly granted themselves and insiders preferential loan terms and waived various fees on their own Credit Union accounts.

The Credit Union's CEO and two staff were each involved and benefited from the alleged fraud. These individuals allegedly falsified documentation to grant loans to themselves, family members, board members, and other members of the Credit Union. Alleged falsified documentation used to perpetrate the alleged fraud included falsified approvals of new loans or advances on existing loans. For example, the CEO admitted to signing her deceased mother's name to obtain loan advances on her mother's trust account. The proceeds of the loan were disbursed directly to the CEO and an immediate family member of one of the Credit Union's two employees for their personal benefit.

Credit Union policy requires all loans to employees or officials over \$10,000 be approved by the Board of Directors. Loans to employees or officials of greater than \$20,000 must obtain loan officer approval, as well as approval from two of the three active Board members. On multiple occasions, signatures of Board members indicating approval of insider loans were allegedly falsified. A third-party fraud examiner, hired by the Credit Union Board, identified multiple loans granted to the Board Chairman which were not supported by signed loan documents. In certain cases, loan documents would be prepared and dated without a signature. Email evidence indicates these loan documents were dated and prepared with the intention of obtaining the applicable signature later to satisfy an NCUA examiner request, if necessary.

Loan file documentation was allegedly altered by management in certain scenarios to give the appearance of strong credit quality. For example, a third-party fraud examination identified instances of management allegedly altering credit report information to show higher credit scores for select borrowers. Additionally, title documentation was allegedly falsified to support proper perfection of collateral for certain loans. The alleged fraudulent loan documentation disguised



heightened credit risk within the Credit Union's loan portfolio, which ultimately led to increased loan losses and the failure of INFCU.

NCUA Examination Process

Total Analysis Process

The NCUA uses a total analysis process that includes collecting, reviewing, and interpreting data; reaching conclusions; making recommendations; and developing action plans. The objectives of the total analysis process include evaluating CAMEL components and reviewing qualitative and quantitative measures.

NCUA uses the CAMEL Rating System for evaluating the soundness of credit unions on a uniform basis, the degree of risk to the SIF, and for identifying those institutions requiring special supervisory attention or concern. The CAMEL rating includes consideration of key ratios, supporting ratios, and trends. Generally, the examiner uses the key ratios to evaluate and appraise the credit union's overall financial condition. At the conclusion of an examination, examiners assign a CAMEL rating.

Examiner judgment affects the overall analytical process. An examiner's review of data includes structural analysis,⁴ trend analysis,⁵ reasonableness analysis,⁶ variable data analysis,⁷ and qualitative data analysis.⁸ Numerous ratios measuring a variety of credit union functions provide the basis for analysis. Examiners must understand these ratios both individually and as a group because some individual ratios may not provide an accurate picture without a review of the related trends.

Financial indicators such as adverse trends, unusual growth patterns, or concentration activities can serve as triggers of changing risk and possible causes for future problems. The NCUA also instructs examiners to look behind the numbers to determine the significance of the supporting ratios and trends. Furthermore, the NCUA requires examiners to determine whether material negative trends exist, ascertain the action needed to reverse unfavorable trends, and formulate, with credit union management, recommendations, and plans to ensure implementation of these actions.

⁴ Structural analysis includes the review of the component parts of a financial statement in relation to the complete financial statement.

⁵ Trend analysis involves comparing the component parts of a structural ratio to itself over several periods.

⁶ As needed, the examiner performs reasonableness tests to ensure the accuracy of financial performance ratios.

⁷ Examiners can often analyze an examination area in many ways. NCUA's total analysis process enables examiners to look beyond the "static" balance sheet figures to assess the financial condition, quality of service, and risk potential.

⁸ Qualitative data includes information and conditions that are not measurable in dollars and cents, percentages, numbers, etc., which have an important bearing on the Credit Union's current condition, and its future. Qualitative data analysis may include assessing lending policies and practices, internal controls, attitude and ability of the officials, risk measurement tools, risk management, and economic conditions.



Risk-Focused Examination Program

In 2002, the NCUA adopted a Risk-Focused Examination (RFE) Program. Risk-focused supervision procedures often include reviewing off-site monitoring tools and risk evaluation reports as well as on-site work. The RFE process includes reviewing seven categories of risk: *Credit, Interest Rate, Liquidity, Transaction, Compliance, Strategic, and Reputation.*

Examination planning tasks may include: (a) reviewing the prior examination report to identify the credit union's highest risk areas and areas that require examiner follow-up; and (b) analyzing Call Reports as well as the risks detected in the credit union's operations and in management's demonstrated ability to manage those risks. A credit union's risk profile may change between examinations. Therefore, the supervision process encourages the examiner to identify those changes in profile through:

- Review of quarterly financial performance, risk, and Call Reports,
- Communication with credit union staff, and
- Knowledge of current events affecting the credit union.

On November 20, 2008, the NCUA Board approved changes to the risk-based examination scheduling policy, creating the Annual Examination Scheduling Program (AEP).⁹ The NCUA indicated these changes were necessary due to adverse economic conditions and distress in the nation's entire financial structure, which placed credit unions at greater risk of loss. The NCUA stated that the Annual Examination Scheduling Program would provide more timely, relevant, qualitative, and quantitative data to recognize any sudden turn in a credit union's performance.

In 2016, the NCUA revised its examination policy¹⁰ that resulted in additional minimum required examination procedures based on a national review of risk. The policy directed a periodic national review of risk issues and adjustment to the minimum review procedures. The NCUA indicated the intent of the policy was to shape its examination and supervision program to consistently identify and mitigate emerging risks in response to changing environmental factors within the credit union industry. As a result of this policy, the NCUA Office of Examination and Insurance (E&I), with input from the regions, now updates the minimum scope procedures, as necessary, by focusing on emerging risks, risk monitoring observations, results of quality control reviews, regulatory changes, and lessons learned from NCUA OIG Material Loss Reviews. The NCUA reviews and updates the minimum examination scoping steps on an annual basis.

⁹ The AEP requires either an examination or a material on-site supervision contact within a 10 to 14-month timeframe based on risk-based scheduling availability.

¹⁰ In December 2016, the NCUA released the Risk-Based Examination Scheduling Policy in Letter to Credit Unions 16-CU-12.



Small Credit Union Examination Program

In 2011, NCUA's Region I (now a part of the NCUA Eastern Region) piloted the Small Credit Union Examination Program (SCUEP) to determine whether examination resources could be better aligned with industry risks. Essentially, the SCUEP expanded the minimum required examination scope for nationally identified areas of elevated risk and reduced the minimum required examination scope in CAMEL 1, 2, or 3 federal credit unions with less than \$50 million in total assets.¹¹

Based on the success of the pilot, the NCUA established the SCUEP on a national basis in January 2012. NCUA officials indicated that the new scope requirements supplement existing RFE practices and do not replace the examiner's judgment and responsibility to refine and adjust their scope, noting that examiners should continue to follow the concepts of the RFE process outlined in the Examiner's Guide for areas of elevated risk.

In 2015, the NCUA issued instructions that established requirements for defined-scope examination with tiered procedures for SCUEP-eligible federal credit unions. Effective in 2015,¹² SCUEP exams were required to focus resources on the areas that presented the greatest potential risk to the SIF in those institutions: internal controls, recordkeeping, and lending.

¹¹ The original SCUEP threshold, introduced in 2011, applied to federal credit unions with \$10 million or less in assets. The NCUA revised this policy with Instruction No. 5000.20 (Rev. 9) on December 27, 2017, to \$30 million or less in assets, and again with Instruction No. 5000.20 (Rev. 10) on January 2, 2019, to \$50 million or less in assets.

¹² NCUA required field staff to complete the small credit union examination training before they could perform a SCUEP defined-scope examination.



RESULTS IN DETAIL

We determined Indianapolis' Newspaper Federal Credit Union failed due to alleged fraudulent activities perpetrated by Credit Union management, employees, and the Chairman of the Credit Union's Board of Directors. The alleged fraud was executed through a loan lapping scheme – a practice that involves falsifying internal loan records to hide misappropriated cash, as well as using fraudulent loan advances to make payments on existing loans, thus concealing delinquencies and uncollectible loans.

From July to September 2020, NCUA officials identified approximately \$1.3 million of fraudulent loans as part of the loan lapping scheme. After identifying the scheme, the NCUA placed INFCU into conservatorship on January 14, 2021. NCUA Southern Region officials executed liquidation orders for the Credit Union on March 31, 2021. The NCUA Board designated the Asset Management and Assistance Center (AMAC) as liquidating agent per the *Order of Liquidation*.

Contributing factors in the failure of the Credit Union included issues with management integrity, ineffective board oversight, and unsafe and unsound lending practices.

A. Why the Credit Union Failed

Management's Actions Caused the Credit Union to Fail

We determined that management's alleged fraudulent activities, primarily related to loan lapping activity, which masked delinquencies and uncollectible loans, caused the Credit Union to fail. Below are the specific factors that we believe allowed this alleged fraud to remain undetected for an extended period.

Lack of Management Integrity

We determined the Credit Union's management, specifically the former CEO, did not conduct the business of the Credit Union in the best interest of its members. Specifically, examiners discovered approximately \$1.3 million in alleged fraudulent loans for which payments had been made through a "loan lapping" scheme. The scheme involved using proceeds from loans to pay-off previously granted loans, and/or to make payments on existing loans to conceal reported delinquencies. After the discovery of the alleged fraud, the Credit Union's loan losses increased, requiring additional provision for loan losses expense to be recorded. The increased expense caused members' equity at the Credit Union to become negative, and the Credit Union to become insolvent.

The Credit Union CEO, Credit Union staff, and the Board Chairman were allegedly involved in the fraudulent activities. Management allegedly falsified loan documentation to provide better rates and additional advances on loans to herself and to related parties. Alleged falsified loan documentation included multiple instances of forged signatures on loan documents, signatures



indicating loan approvals, credit reports and security titles, among others. After being confronted with the alleged fraud by NCUA officials, the CEO admitted to signing her mother's name on certain documents after her death to obtain loan disbursements.

Interviews with current and former NCUA examiners involved in oversight of the Credit Union indicated the CEO and Credit Union employees were not forthcoming with information regarding their relationships. For example, prior to the identification of the alleged fraud, none of the examiners we interviewed were aware the CEO and another employee of the Credit Union were sisters. Other interviewees suspected the CEO of having a relationship with a member who held a significant concentration of loans, up to 47 percent of net worth, based on email correspondence obtained by the NCUA after identification of the alleged fraud. Examiners advised us that had they been aware, these relationships would have been considered as part of their risk assessment of the Credit Union and evaluation of segregation of duties.

NCUA examiners also identified instances of the CEO waiving overdraft and non-sufficient funds (NSF) fees on personal accounts and those of family members. During an examination effective September 30, 2019, examiners identified the CEO's and other employee's accounts as being exempt from overdraft and NSF fees. The examiner later indicated that management and their family members were not paying any fees. After being confronted, the CEO stated it must have been an error.

In late 2020, the INFCU Board of Directors engaged a third party to conduct a fraud investigation of certain activities and improper actions of the Credit Union's former CEO. The investigation concluded that the CEO took improper actions for personal gain and/or to provide preferential treatment to certain members of the Credit Union. Specific actions identified by the third party, which before this had been identified by the NCUA, included:

- Evidence of the CEO using proceeds from an improperly recorded loan for her own personal benefit.
- Investigation of the CEO's emails show emails to Credit Union members, or the Board Chairman, asking that they sign loan documents requested by NCUA examiners, and/or requesting they backdate or not date the loan documents with their signature.
- Several Credit Union members, who came into the Credit Union branch after the CEO was terminated, stated the CEO always "took care of it" when they were behind on loan payments.

Ineffective Board Oversight

The Board of Directors, specifically the Board Chairman, failed in their duties as required by NCUA Rules and Regulations. Evidence indicates that the Chairman of the Board was involved in the alleged loan lapping scheme. NCUA examiners identified inappropriate activity with the



Board Chairman's Credit Union account where cash out refinances, or loan advances on a line of credit, were consistently used as the only source of repayment on his loans. Similar activity was also identified on accounts belonging to the Board Chairman's spouse. After being questioned, the CEO admitted to refinancing loans multiple times and using the proceeds to make loan payments on behalf of the Board Chairman when the Chairman and his spouse communicated to her, they were experiencing financial difficulties. The Chairman resigned from the Board shortly after NCUA examiners presented evidence of the loan lapping scheme.

Due to the limited number of employees at the Credit Union, insider loans were to be approved by the majority of board members, depending on the loan amount. This segregation of duties was circumvented by the alleged falsification of board member signatures on multiple occasions. Loan documentation for several loans to the Board Chairman were also allegedly falsified. Total loans to the Board Chairman exceeded policy restrictions of 10 percent of unimpaired capital.

Evidence obtained by the NCUA examiners also indicated INFCU Board minutes to be fictitious. Board meeting minutes were not printed and signed and were maintained by two individuals allegedly involved in the loan lapping scheme – the CEO and the Board Chairman. Examiners also learned certain months had two sets of Board minutes, with inconsistent information included. For example, examiners found for September 2018, multiple versions of the minutes existed. One version documented a report presented by the Supervisory Committee Chairperson, and the other version did not list the Supervisory Committee Chairperson as being in attendance.

Unsafe and Unsound Lending Practices

Credit Union staff failed to manage their loan portfolio in a safe and sound manner. Specifically, examiners identified unsafe lending practices in findings regarding loan concentrations to one household and large unsecured lending limits, among others. The Credit Union consistently granted loans to one member, or one household, of greater than 25 percent of net worth. Examiners documented loans to one household equaling 47 percent of net worth during the September 2018 examination. We determined this individual had the potential to drop the Credit Union's net worth to prompt corrective action territory if they were to experience financial difficulty and the Credit Union were to incur significant loan losses. During each examination, NCUA field staff documented the approximate balance of the largest household concentration as of the examination date. Loan balances to one household, as a percentage of net worth, during the period under review were as follows:

- September 30, 2016 – 29 percent of net worth
- September 30, 2017 – 36 percent of net worth
- September 30, 2018 – 47 percent of net worth
- September 30, 2019 – 43 percent of net worth

As shown above, concentrations to borrowers within one household continued to increase and remain elevated even as NCUA examiners expressed concern over the heightened credit risk to



the Credit Union's loan portfolio. Examiners issued a DOR during the September 30, 2018, examination over a "Maximum Indebtedness Limit," which requested the Credit Union develop a reasonable maximum indebtedness limit per member and/or household as a percentage of net worth to prevent similar concentrations to occur in the future. The DOR was resolved during the September 30, 2019, examination when the Credit Union developed a \$150,000 maximum aggregate loan amount per household. However, the Credit Union was then in violation of its own policy for maximum indebtedness limits to one household. We believe had examiners revised the DOR instead of resolving it, they could have determined whether the original DOR was reasonable, and thus could have determined exactly how the Credit Union intended to comply with its own policy.

Additionally, the Credit Union's loan portfolio contained an elevated concentration of unsecured loans. During 2018, management implemented an unsecured line of credit of \$35,000 per top tier borrower under the Credit Union's policy. NCUA examiners identified the unsecured loans as a high risk, and specifically noted instances of a husband and wife taking \$70,000 in unsecured debt simultaneously. When evaluated in aggregate with unsecured limits offered to Credit Union members from other institutions, a single household was able to originate over \$100,000 in unsecured debt. Along with the high credit risk, examiners communicated concerns with the lack of internal control over originations of unsecured debt, as the Credit Union did not evaluate debt to income as an unsecured debt ratio and did not have controls in place to limit the aggregate amount of unsecured debt being granted to members. These concerns were included in a DOR issued during the September 30, 2018, examination.

Other unsafe and unsound lending practices included the Credit Union granting Member Business Loans (MBLs) to members without having a Board approved MBL policy in place. Examiners suspected certain MBLs were granted with the purpose of circumventing loan policy limits for unsecured loans to a single household, or to make payments on other delinquent loans. The Credit Union also granted MBLs underwritten and priced as consumer loans, as shown through loan approval documents.

Although the Credit Union continued to be unprofitable and loan delinquencies continued to rise during the scope period of our review, high risk loans continued to be granted to members. Ultimately, once examiners identified the loan lapping scheme and exposed previously concealed loan delinquencies, the Credit Union was not able to fund the ALLL to adequate levels without becoming insolvent.



B. NCUA's Supervision of the Credit Union

NCUA Examiners May Have Mitigated the Loss to the Share Insurance Fund

We believe if examiners had sufficiently completed certain SCUEP steps, and related follow-up steps as designed by the SCUEP, they may have identified the loan lapping scheme earlier. The SCUEP steps, when properly performed, appear to have been designed appropriately to address fraud risk. However, based on our discussions

with various examiners, there appears to be an overall inconsistency of understanding as to the correct way to complete certain SCUEP steps. We believe the inconsistency of execution of SCUEP steps may be due to training issues and may be influenced by the limited timeline required for the completion of examinations of small credit unions. Finally, we determined that the NCUA's established single borrower limit, which is 10 percent of unimpaired capital and surplus¹³ (including shares), exposes small credit unions such as INFCU to a significant risk of loss. Single borrowers at INFCU held aggregate loans of up to 47 percent of net worth, a level with the potential to drop the Credit Union into prompt corrective action if a significant loss were to be incurred due to the borrower experiencing financial difficulty. Although this concentration appears to be high risk, it did not technically violate the current single borrower limit. Had the single borrower limit been lower, field staff may have been able to employ more timely and aggressive enforcement actions to address elevated concentration risks identified at the Credit Union.

Failure to Answer "Yes" and Expand Testing for Certain SCUEP Procedures

NCUA Instruction No. 5000.20 (Rev. 6) issued on January 26, 2015, established examination requirements for federally insured credit unions that were SCUEP eligible (asset size of less than \$30 million and CAMEL rating of 1, 2, and 3). The SCUEP exam procedures took effect in 2015.

Based on our review, NCUA examiners appear to have failed to answer "yes" for certain SCUEP steps that were identified to have issues within examination reports. By answering "yes" to TIER 1 review questions, examiners would have been required to perform additional procedures (TIER 2 and TIER 3 review steps), which may have led to the alleged fraud being uncovered earlier.

For example, SCUEP procedure Le C-1 asks the examiner to:

"Review the standard loan queries in AIRES (or credit union management reports, if a download cannot be obtained). Did the review identify any anomalies in need of additional review?"

¹³ Unimpaired capital and surplus means shares plus post-closing undivided earnings. This does not include regular reserves or special reserves required by law, regulation or special agreement between the credit union and its regulator or share insurer. "Paid-in and unimpaired capital and surplus" for purposes of the Central Liquidity Facility is defined in 12 C.F.R. § 725.2(n).



The “Results of Review” section of the SCUEP indicate an Examiner Finding during 2016 and 2017 related to procedure Le C-1. The finding included concerns with paid ahead lines of credit, accrued interest greater than loan balances, etc. Although an Examiner Finding was issued, the “answer” column was marked “no” for both years. If the examiner had answered “yes” in either year, the examiner would have been asked to review payment histories for specific loans with anomalies as a required TIER 2 procedure. We believe performing the additional step may have resulted in earlier identification of the alleged fraud.

Another example, SCUEP procedure Le F-1, asks the examiner to:

“Review Member Concentrations. Did the concentration review identify any large loan concentrations in need of further review?”

This SCUEP step was marked “no” within the SCUEP workbook for the 2016 examination, even though the examiner indicated the Credit Union had \$314,000 in loans to one borrower within the “Results of Review” section. We determined this would indicate a concentration representing approximately 29 percent of net worth. This SCUEP step was also marked “no” within the SCUEP workbook for the 2017 examination, although the examiner indicated the Credit Union had \$355,000 in loans to one borrower within the “Results of Review” section. We determined this would indicate a concentration representing approximately 36 percent of net worth. Had the question been marked “yes” in either examination, examiners would have been required to pull a sample of the Credit Union’s highly concentrated loan files and evaluate the source of repayment as a required TIER 2 procedure. We believe performing this additional step may have resulted in earlier identification of the loan lapping scheme.

Because examiners answered “no” to these SCUEP procedures, expanded TIER 2 or TIER 3 procedures were not required to be performed. Examiners we interviewed indicated that these answers are largely dependent on the judgment of the examiner. When asked about the failure to answer “yes” to certain SCUEP steps, examiners also referenced the limited time (40 hours) allotted to complete examinations of small credit unions. The examiners we spoke to did not consider 40 hours to be enough time to effectively complete all steps required in a SCUEP examination, and some stated that the NCUA’s emphasis on efficiency may have impacted the “yes” or “no” responses in the SCUEP. Although TIER 2 and 3 SCUEP steps appear to be designed effectively to identify a loan lapping scheme, these steps are not required to be completed unless the examiner first answers “yes” to the TIER 1 step.

Failure to Adequately Train Examiners on SCUEP Procedures

Interviews of NCUA examiners indicated an inconsistent understanding of procedures required to complete certain SCUEP steps. For example, a particular TIER 2 SCUEP procedure requires the examiner identify the source of repayment for highly concentrated credit union loans. While the NCUA does rely on examiner judgement for responding to SCUEP steps, we believe the elevated concentrations within INFCU’s loan portfolio would require examiners to perform the TIER 2 SCUEP step and test the source of repayment. Several examiners indicated the appropriate way to complete this step is to observe the actual source the borrower used to make



loan payments. For situations where examiners determined the source of repayment was from funds within the credit union, a more detailed review would be required. Other examiners explained they would review the credit quality of a loan when performing this step, specifically the ability of the member to repay the loan. These examiners, however, did not test the actual source of repayment of loans when completing the SCUEP procedure.

As previously discussed, the CEO and Credit Union employees were well versed in concealing alleged fraudulent loans and advances through alleged falsification and manipulation of Credit Union records. However, had examiners appropriately performed TIER 2 SCUEP procedures and requested additional documentation over sources of repayment, despite the CEO possibly providing falsified documents to satisfy the request, we believe an evaluation of the source of repayment for loans included in the loan lapping scheme may have identified the source as internal Credit Union accounts, including advances on other loans. SCUEP steps, when sufficiently performed, appear to be designed appropriately to address risk of fraud caused by a loan lapping scheme. However, when examiners do not inspect the source of repayment for certain loans, including necessary follow-up for repayments from credit union accounts, loan lapping schemes, such as what occurred in INFCU, may occur and are difficult to discover.

NCUA Loan Limits to a Single Borrower

The NCUA has established a single borrower limit,¹⁴ which specifies the credit union may not advance to a member in the aggregate more than 10 percent of the credit union's total unimpaired capital and surplus. Unimpaired capital and surplus are defined as shares plus post-closing, undivided earnings.

The NCUA currently has separate regulations limiting concentrations of specific loan types such as loan participations and commercial loans. These loan concentration limits are calculated as a percentage of net worth, and do not consider shares as a part of the calculation. By including shares within the definition of unimpaired capital and surplus, the single borrower limit exposes credit unions to a significant risk of loss specific to capital. The table below summarizes the maximum level of net worth exposed to loss if INFCU were to extend loans to a single borrower of 10 percent of total unimpaired capital and surplus:

	12/31/2016	12/31/2017	12/31/2018	12/31/2019
Total INFCU Unimpaired Capital and Surplus:	\$7,468,313	\$7,551,134	\$7,312,172	\$7,163,508
10% of Unimpaired Capital and Surplus (NCUA Single Borrower Limit):	746,831	755,133	731,217	716,351
INFCU Net Worth:	1,004,057	932,029	730,643	727,901
Single Borrower Limit as a % of INFCU Net Worth:	74%	81%	100%	98%

Based on the table above, a range of 74 percent to 100 percent of total net worth had the potential to be exposed to loss due to a concentration to a single borrower under the NCUA's current rule

¹⁴ 12 U.S.C. § 1757(5)(x); 12 C.F.R. § 701.21(c)(5).



during our period of review. These levels had the potential to reduce INFCU's capital ratios to being "undercapitalized." As previously detailed, INFCU's loan portfolio had consistently elevated concentrations to a single borrower during each examination within our period of review.

Although NCUA field staff identified INFCU's concentrations to a single borrower as a substantial credit risk during each exam, examiners appeared to have had more difficulty applying timely and aggressive enforcement actions to the Credit Union, as the concentration levels did not exceed 10 percent of unimpaired capital and surplus. An example of the difficulty to apply aggressive enforcement action is shown when a DOR was issued during the September 30, 2018, examination over a "Maximum Indebtedness Limit," which requested the Credit Union develop a reasonable maximum indebtedness limit per member and/or household as a percentage of net worth to prevent similar concentrations to occur in the future. The DOR was resolved during the September 30, 2019, examination when the Credit Union developed a \$150,000 maximum aggregate loan amount per household. Although the DOR was resolved, significant single borrower concentrations still existed within INFCU's loan portfolio. These elevated concentrations, along with the alleged fraudulent activities perpetrated by Credit Union management, ultimately led to the failure of INFCU.



OBSERVATIONS AND RECOMMENDATION

A. Observations

Important observations from our review of Indianapolis' Newspaper Federal Credit Union include:

- NCUA examiners appear to identify and document certain areas of heightened risk through the completion of required SCUPEP procedures. The SCUPEP steps, including additional TIER 2 and 3 steps required after answering "yes" to a TIER 1 step, appear to be appropriately designed to detect a loan lapping scheme. However, as the decision to proceed with TIER 2 and 3 steps are highly dependent on examiner judgement, they are not performed consistently.
- Interviews with NCUA examiners indicated an inconsistent understanding of procedures required to complete certain SCUPEP steps. Specifically, examiners' understanding of how they would evaluate repayment sources for highly concentrated credit union loans appears to vary. Additional clarification through SCUPEP training, or an increased emphasis on the nature of the fraud risk through training may aid in a more consistent application of the examination step.

Based on our audit work and observations above, we are making one recommendation.

B. Recommendation

We recommend NCUA management:

1. Enhance annual Small Credit Union Examination Program training related to concentration risk. Enhanced examiner training should include additional emphasis on applicable NCUA guidance (e.g., NCUA Letter to Credit Unions, 10-CU-03 – Concentration Risk), as well as discussion and training related to the application and enforcement of such guidance. Training should also include discussion of the importance of application to smaller credit unions and the risk of loss to the Share Insurance Fund.

Management Response

Management agreed with our recommendation. Management indicated they will work with stakeholders to review SCUPEP training, including a discussion of the procedures to identify and review potential concentration risk in small credit unions. The work will be completed by December 31, 2022.

OIG Response

We concur with management's planned actions.



Appendix A

OBJECTIVES, SCOPE, AND METHODOLOGY

We performed this material loss review to satisfy the requirements of Section 216(j) of the FCU Act, 12 U.S.C. §1790d(j), which requires the OIG to conduct a material loss review when the SIF has incurred a material loss, or when unusual circumstances exist that warrant an in-depth review of the loss.¹⁵ We determined unusual circumstances existed related to the failure of INFCU to warrant the OIG conducting a full-scope MLR.

The objectives of the MLR were to:

1. Determine the cause(s) of the Credit Union's failure and the resulting loss to the SIF;
2. Assess the NCUA's supervision of the institution, including implementation of the Prompt Corrective Action (PCA) requirements of Section 216 of the FCU Act; and
3. Make appropriate observations and/or recommendations to prevent future losses.

To accomplish our review, we performed fieldwork virtually. The scope of this review covered the period from September 30, 2016, through June 30, 2020.

To determine the cause(s) of the Credit Union's failure and assess the adequacy of NCUA's supervision, we:

- Completed a risk assessment, which included a review of the Examination Overviews as well as other risk considerations, including consideration of minimum scope requirements for examiners.
- Prepared a chronology and summary table of regulatory examinations, which include examination date, regulator, CAMEL rating, supervisory actions, and significant examiner comments.
- Reviewed examination files, including examination reports, risk assessments, examination findings, confidential sections, examination spreadsheet files, correspondence, analysis, and other documentation.
- Reviewed summaries of the Credit Union's Board of Directors minutes and Board packets, as well as summaries of Supervisory Committee minutes provided.

¹⁵ The FCU Act deems a loss "material" if the loss exceeds the sum of \$25 million and an amount equal to 10 percent of the total assets of the credit union at the time in which the NCUA Board initiated assistance under Section 208 or was appointed liquidating agent pursuant to the Act.



- Reviewed the external reports on Supervisory Committee audits, agreed-upon procedures and member account verification, including results, findings, and responses, as provided.
- Conducted interviews with Southern Region management and staff involved with the examination, supervision, and liquidation of the Credit Union.
- Downloaded Call Reports for the scope period and performed analysis of a number of financial indicators, including capital adequacy ratios, return on average assets and equity, and asset quality ratios, and other elements of the balance sheet and income statement.
- Considered allegations of fraud, including means of misappropriation and potential warning signs.
- Developed a timeline and summary of enforcement actions taken by the NCUA from 2016 through liquidation.
- Assessed NCUA supervision and evaluated the timeliness of supervisory actions.
- Assessed the effectiveness of the Credit Union's management, and oversight by the Supervisory Committees and Board of Directors.

We relied upon materials provided by NCUA Southern Region and AMAC officials, including information and other data collected during interviews.

We used computer-processed data from NCUA's AIRES and NCUA online systems. We did not test controls over these systems; however, we relied on our analysis of information from management reports, correspondence files, and interviews to corroborate data obtained from these systems to support our conclusions.

We conducted this audit from May 2021 to December 2021 in accordance with generally accepted government auditing standards and included such tests of internal controls as we considered necessary under the circumstances. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.



Appendix B

NCUA MANAGEMENT RESPONSE



National Credit Union Administration
Office of the Executive Director

SENT BY EMAIL

TO: Inspector General James Hagen
Office of Inspector General

FROM: Executive Director Larry Fazio

SUBJ: Management Response - Material Loss Review of Indianapolis' Newspaper FCU

DATE: December 13, 2021

LARRY FAZIO Digitally signed by LARRY FAZIO
Date: 2021.12.13 16:12:06 -0500

Thank you for the opportunity to comment on recommendation included in the Office of the Inspector General's draft report titled *Material Loss Review of Indianapolis' Newspaper Federal Credit Union*. We agree with the recommendation and have provided our response below.

Recommendation: *We recommend NCUA management enhance annual Small Credit Union Examination Program training related to concentration risk. Enhanced examiner training should include additional emphasis on applicable NCUA guidance (e.g., NCUA Letter to Credit Unions, 10-CU-03 – Concentration Risk), as well as discussion and training related to the application and enforcement of such guidance. Training should also include discussion of the importance of application to smaller credit unions and the risk of loss to the Share Insurance Fund.*

Response: The Office of Examination and Insurance will work with stakeholders to review SCUEP training, including a discussion of the procedures to identify and review potential concentration risk in small credit unions. The work will be completed by December 31, 2022.

Thank you for allowing the opportunity to comment.

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Appendix C

ACRONYMS AND ABBREVIATIONS

Acronym	Term
AEP	Annual Examination Scheduling Program
AIRES	Automated Integrated Regulatory Examination System
ALLL	Allowance for Loan & Lease Losses
AMAC	Asset Management Assistance Center
Call Reports	NCUA 5300 Call Reports
CAMEL	[C]apital Adequacy, [A]sset Quality, [M]anagement, [E]arnings, and [L]iquidity/Asset-Liability Management.
CDs	Certificates of Deposit
CEO	Chief Executive Officer
CPA	Certified Public Accountant
The Credit Union	Indianapolis' Newspaper Federal Credit Union
DOR	Document of Resolution
DOS	Division of Supervision
DSA	Division of Special Assets
EF	Examiner's Finding
EIC	Examiner In-Charge
FCU Act	Federal Credit Union Act
FPR	Financial Performance Report
GAGAS	Generally Accepted Government Auditing Standards
INFCU	Indianapolis' Newspaper Federal Credit Union
MBL	Member Business Loans



Acronym	Term
MLR	Material Loss Review
NCUA	National Credit Union Administration
NSF	Non-Sufficient Funds
OIG	Office of Inspector General
PCA	Prompt Corrective Action
RD	Regional Director
RFE	Risk-Focused Examination
SCUEP	Small Credit Union Examination Program
SE	Supervisory Examiner
SIF	Share Insurance Fund
WCC	Work Classification Code